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In The Supreme Court of the United States

MORGAN STANLEY CAPITAL GROUP INC.,

Petitioner,

v.

PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY, WASHINGTON, ET AL.,

Respondents.

CALPINE ENERGY SERVICES, L.P., ET AL.,

Petitioners,

v.

PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY, WASHINGTON, ET AL.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF OF THE RESPONDENTS PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA AND CALIFORNIA ELECTRICITY OVERSIGHT BOARD

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QUESTIONS PRESENTED

1. Does the Federal Power Act require that there be in the case of all contracts for wholesale electricity at least one opportunity for the Federal Energy Regulatory Commission to judge whether the rates are just and reasonable?

2. Does the mere *ex ante* grant of market-based rate authority to the seller of wholesale electricity adequately provide such an opportunity, even when the subsequent rates themselves are the excessive product of a non-competitive market?

PARTIES TO THE PROCEEDINGS BELOW

Supplementing the information set forth in the Briefs of Petitioners and of Respondent Federal Energy Regulatory Commission, Respondents Public Utilities Commission of the State of California ("CPUC") and California Electricity Oversight Board ("CEOB") state that they were intervenors in the court of appeals and are Respondents here "by rule." *See* Sup. Ct. R. 12.4, 12.6.

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STATEMENT

This case arises out of the anti-competitive conditions that plagued the Western energy markets in 2000-2001, described by the Federal Energy Regulatory Commission ("FERC" or "Commission") as "the worst electricity-market crisis in American history." FERC Opp. Br. 12; *see also id.* 22.[1] At the height of that market crisis – as generating facilities inexplicably went off-line or were otherwise unavailable, prices skyrocketed and blackouts became a near-daily occurrence – the California Department of Water Resources ("CDWR") executed fifty-seven long-term or "forward" energy contracts at the urging of FERC and under FERC's assurance that it would "vigilant[ly]" monitor rates in those contracts to ensure that they were "just and reasonable." J.A. 520a, 522a. This appeal concerns FERC's subsequent denial of any opportunity to have the justness and reasonableness of such contract rates assessed. This case is not about whether competitive wholesale power markets are desirable or achievable. This case is simply about

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[1] All references to "FERC Opp. Br." are to the brief of Respondent FERC in opposition to petitions for certiorari; all references to "FERC Br." are to the merits brief of Respondent FERC; all references to "MSCG Br." are to the merits brief of Petitioner Morgan Stanley Capital Group, Inc.; all references to "Calp. Br." are to the merits brief of Petitioners American Electric Power Service Corporation, Allegheny Energy Supply Company, and Calpine Energy Services, L.P.; all references to "Coral Br." are to the merits brief of *amici* Coral Power, L.L.C., Dynegy Power Marketing, Inc., PPM Energy, Inc., and Sempra Generation.

FERC's irreducible obligation under the Federal Power Act, 16 U.S.C. 791a-828r ("FPA" or "Act"), to determine whether contract rates are unjust and unreasonable.

CPUC and CEOB (collectively referred to herein as "Intervenors") are charged with representing the interests of California consumers of electricity. *See* Cal. Const. art. XII; Cal. Pub. Util. Code 307(b), 335(e), 341(m). Their role in protecting the public is recognized under federal law. Section 308 of the FPA authorizes FERC to admit CPUC and CEOB as parties to any proceeding before it in which they are interested, *see* 16 U.S.C. 825g(a), and FERC by rule allows CPUC to intervene as of right, without motion, upon timely notice, *see* 18 C.F.R. 385.214(a)(2). In this regard, the FPA reflects a "special solicitude" for state authorities "designed to recognize precisely the interest of the states in protecting their citizens in this traditional governmental field of utility regulation." *Md. People's Counsel v. FERC*, 760 F.2d 318, 320-21 (D.C. Cir. 1985) (Scalia, J.). In that capacity, state agencies have standing before FERC to protect the interests of the public, apart from the interests of the signatories to a challenged contract. *Id.* Intervenors are not signatories to the contracts they challenge here and appear in these proceedings in order to protect the interests of the public.

In 2002, Intervenors commenced complaint proceedings before FERC pursuant to Section 206 of the FPA, 16 U.S.C. 824e, seeking review of the CDWR

forward contracts. *See* J.A. 1125a-27a. Those proceedings went forward on a parallel track with the proceedings commenced by the Washington, California and Nevada load-serving entities that also are Respondents in this case. *See* J.A. 1082a-94a.[2] Like Snohomish, Intervenors do not claim that the challenged contracts became unjust and unreasonable as a result of developments after they were signed. Instead, the claim is that the contracts were unjust and unreasonable on the day they were signed.

FERC referred the complaints in the Snohomish docket and the CPUC docket for hearings before separate Administrative Law Judges ("ALJs"). The hearing on Snohomish's complaints resulted in findings of fact by the assigned ALJ. Pet. App. 68a-245a. The hearing on Intervenors' complaints was terminated by FERC without any findings of fact on the merits of the claims, on which the Commission itself heard final argument. J.A. 1324a-1482a. On the same day, June 26, 2003, FERC issued orders in each docket adopting, in each instance by a 2-1 vote, identical conclusions of law and rationales. *Id.* (CPUC Order); J.A. 1222a-1323a (Snohomish Order). FERC denied requests for rehearing in the two dockets by

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[2] Respondents Nevada Power Company; Sierra Pacific Power Company; Office of the Nevada Attorney General, Bureau of Consumer Protection; Southern California Water Company (n/k/a Golden State Water Company); and Public Utility District No. 1 of Snohomish County, Washington will be referred to here collectively as "Snohomish."

separate orders also issued on the same day, November 10, 2003. J.A. 1554a-1614a (Snohomish Order); J.A. 1483a-1553a (CPUC Order).

Appeals followed to the U.S. Court of Appeals for the Ninth Circuit. Intervenors directly appealed FERC's decision in the CPUC docket, and intervened in the appeal from the decision in the Snohomish docket. The court of appeals treated the Snohomish docket appeal and the CPUC docket appeal as companion cases, heard oral argument on the same day, and issued its decisions on the merits on the same day. Pet. App. 1a-67a (*Pub. Util. Dist. No. 1 of Snohomish County v. FERC*, 471 F.3d 1053 (9th Cir. 2006) ("*PUD*")); Pet. App. 314a-30a (*Pub. Utils. Comm'n of Cal. v. FERC*, 474 F.3d 587 (9th Cir. 2006) ("*PUC*")). This Court granted petitions for certiorari in the Snohomish docket and has taken no action on the currently pending petitions for certiorari with respect to the CPUC docket appeals.

I. THE ANTI-COMPETITIVE CONDITIONS OF THE WESTERN ENERGY MARKETS IN 2000-2001

On August 2, 2000, San Diego Gas & Electric Company filed a complaint at FERC, noting the now-undisputed dysfunction in the spot markets,[3] and

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[3] It is conventional to distinguish between contracts executed for delivery within twenty-four hours or less, so-called "spot market" transactions, and longer-term "forward market"

(Continued on following page)

seeking to limit the market-based rate authority of sellers in those markets by imposition of a price cap to mitigate the abuse of market power. J.A. 430a-31a. On August 23, 2000, FERC instituted formal hearing procedures to investigate, among other things, "the justness and reasonableness of the rates of public utility sellers into the [CAISO] and the PX markets, and also to investigate whether the tariffs, contracts, institutional structures and bylaws of the [CAISO] and PX were adversely affecting the wholesale power markets in California." J.A. 785a (Dec. 19, 2000 Order) (describing purpose of hearing set by August 23, 2000 Order (J.A. 429a-62a)).[4]

On November 1, 2000, the Commission concluded that the spot markets were "seriously flawed" and noted "clear evidence that the California market structure and rules provide the opportunity for sellers

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transactions. As the contracts at issue in these cases show, the interim between execution and commencement of delivery can be months or longer, and the duration of the contracts can be as long as ten years or more. The duration of deliveries in spot market transactions typically is limited to a particular day and even to a particular hour or hours within such a day. Pet. App. 23a (*PUD*).

[4] The California Power Exchange ("CalPX" or "PX") operated an auction market for spot trading; the California Independent System Operator ("CAISO") is responsible for maintaining the reliability of the state's transmission grid, and operated a "real-time" market for balancing the load supplied to the grid with the energy actually being consumed at any given moment. Pet. App. 23a (*PUD*); *see also* Act of September 23, 1996, 1996 Cal. Legis. Serv. 854 (A.B.1890).

to exercise market power when supply is tight and can result in unjust and unreasonable rates under the FPA." *San Diego Gas & Elec. Co.*, 93 FERC ¶61,121 at 61,349-50 (2000) ("Nov. 1, 2000 Order"). FERC outlined remedies that were to be implemented on January 1, 2001; but because the crisis was worsening, FERC adopted those remedies earlier to "stop the current electric market hemorrhaging and restore credibility to the electric markets in the West." J.A. 481a (Dec. 15, 2000 Order).

Finding that California's flawed spot markets had caused and potentially would continue to cause "unjust and unreasonable rates for short-term energy," J.A. 489a, FERC in its December 15, 2000 Order "strongly urge[d]" California market participants to enter into long-term contracts covering future deliveries of power for two years or more. J.A. 519a. In issuing this recommendation, FERC acknowledged that moving purchases rapidly into the long-term (forward) market might well create yet another "strong sellers' market." J.A. 522a. To address this concern, FERC expressly committed to "be vigilant in monitoring the possible exercise of market power" and "monitor prices in those [long-term] markets" in order "[t]o address concerns about potentially unjust and unreasonable rates." J.A. 520a, 522a.

In the month following the December 15, 2000 Order, the crisis intensified. CAISO declared thirteen

system emergencies,[5] even though it was winter, and electricity demand was significantly lower than in the summer. (ER-266.) As the former vice president of Southern California Edison explained:

> [I]t made no sense that there were rolling blackouts in January with less than 30,000 MW of peak load, when there had always been sufficient supplies to meet over 40,000 MW of load. . . . Also, approximately 14,000 MW of California generating units were reported to be "off-line" in January; this was unprecedented.

(ER-122-23.)

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[5] There are three stages of CAISO emergencies: Stage One is the least serious, with the Operating Reserve at less than 7.5% of predicted demand; Stage Two is more serious, with the Operating Reserve at less than 5% of predicted demand and power interruptions to customers that have so agreed; Stage Three is the most serious with the Operating Reserve at less than 1.5%, and imminent danger of system collapse and "involuntary curtailments" of power or rolling blackouts. (*See* ER-263-69.) Citations to "Excerpts of Record" ("ER-") in Intervenors' brief refer to the Excerpts of Record submitted to the court of appeals in the underlying *PUC* case, for which petitions for certiorari are pending before this Court. The cited excerpts are relevant to the issues currently before the Court and help to explain the impact of the Western energy crisis on the State of California. *See* Robert L. Stern et al., *Supreme Court Practice* 609 (8th ed. 2002) (materials outside the record that are "judicially noticeable or otherwise relevant . . . may be quoted in the text of the brief itself"). Copies of the entire Excerpts of Record submitted to the court of appeals in the *PUC* case can be provided to the Court upon request.

II. CDWR'S ENTRY INTO POWER PURCHASE CONTRACTS IN ORDER TO STEM THE CRISIS AND KEEP THE POWER ON IN CALIFORNIA

With California's investor-owned utilities ("IOUs") facing insolvency, there were virtually no creditworthy buyers left to purchase power for the State's consumers. The State of California was therefore compelled to step in to protect the welfare, health and safety of its citizens. On January 17, 2001, the Governor declared a State of Emergency and ordered that CDWR "shall enter into contracts . . . for the purchase of electricity . . . as expeditiously as possible." Pet. App. 317a (*PUC*). CDWR was the state agency charged with managing California's reservoirs and dams, which generated at peak 2,000 megawatts ("MW") of electricity. (ER-71-72.) On February 1, 2001, the California Legislature enacted Assembly Bill 1 of the 2001-2002 First Extraordinary Session ("AB1X") authorizing CDWR to purchase power either through the spot or forward markets until December 31, 2002. Cal. Water Code 80000-80270. CDWR thereby inherited the responsibility for purchasing the "net short." (ER-260.)[6]

On January 18, 2001, the first day of CDWR electricity purchases, CAISO was 14,000 MW short of

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[6] The net short is the difference between the State's demand in any given hour and the amount of power already scheduled for delivery. (ER-120.)

the power it needed, fully 45% of the power California needed for that day. (ER-74.)

From January 18 to January 31, CDWR spent $400 million buying electricity at an average price of $321/MWh on the spot market. (ER-272-81.) At the same time, California suffered twelve straight days of Stage Three emergencies. (ER-263-69.) Given that these blackouts occurred in January, the State understandably anticipated that there would be blackouts in the summer of 2001, when the load was expected to be approximately 50% larger. (ER-259.)

Making greater spot market purchases was not a practical alternative.[7] Allowing blackouts (*i.e.*, refusing to pay high prices to make up the net short) was also unacceptable. (ER-372.) With no other viable option, and with FERC's assurance in its December

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[7] As the Deputy Director of CDWR explained:

> In the six month period between January 17 and June 30, 2001, the State spent in total over $5.4 billion in spot market purchases, and another $3.3 billion in other energy purchases in an attempt to avoid blackouts during that period. To put this in perspective, the dollars spent purchasing energy during this six-month period exceeded all other general fund expenditure individual line items for the full calendar year 2001, with the exception of education and public health and human services programs. . . . Thus, continuing to purchase significant power in the spot market, while an "option" in the literal sense, was certainly not a workable one, and especially not for any length of time.

(ER-261-262.)

15 Order that it would vigilantly monitor the forward market for unjust and unreasonable prices, CDWR entered the forward contracts market. (*See* ER-262.) Between February 6 and August 23, 2001, CDWR executed fifty-seven long-term forward contracts with twenty-eight different suppliers that covered energy deliveries for periods up to twenty years. Pet. App. 317a (*PUC*).

In fulfilling its new statutory role to purchase power, CDWR was not acting as a marketer or trading in pursuit of profit; CDWR was acting as the creditworthy buyer to purchase the net short power that the non-creditworthy IOUs no longer could buy in order to serve retail load. *See* Cal. Water Code 80000-80270.[8] By statute, the costs of CDWR's power purchases are passed through directly to ratepayers. *Id.* 80104 ("Upon the delivery of power to them, the retail end use customers shall be deemed to have purchased the power from the department. Payment

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[8] In its Brief, FERC refers to the finding of ALJ Cintron that Snohomish "made millions of dollars in 2001 by reselling" power it purchased from Morgan Stanley and that "SCWC also profited by reselling some of the power it purchased." FERC Br. 12 (citing Pet. App. 218a-219a, 215a). Whatever the relevance of those ALJ findings in the Snohomish docket, they certainly were not outcome determinative; CDWR was not trading for profit in the spot markets, but FERC just as surely denied relief for Intervenors as it did for Snohomish.

for any sale shall be a direct obligation of the retail end use customer to the department.").[9]

III. THE CDWR CONTRACTS

CDWR began assembling its portfolio of forward contracts by contacting all significant California power suppliers and issuing requests for bids. (ER-121.) It became clear, however, that suppliers were unwilling to forego high spot prices "without a very significant premium in the forward contract[s] to reflect that lost opportunity." (ER-124; *see also* ER-120 ("Spot market prices were *1000%* over the prior year's prices (*i.e.*, an average of $310-$320/MWh compared to $30-$40/MWh.)."); ER-285 ("In negotiations sellers regularly said to us words to this effect: 'we are getting $300 a MWh in the spot; how do I tell my stockholders why I agreed to $70 a MWh?'").)

The rates in each of the contracts remaining at issue in the CPUC docket reflect the high spot prices expected for the summer of 2001 and beyond. (*See* ER-413-26 and citations therein; *see also* ER-110.) Certain of the contract prices are strikingly high on their face. *See* Pet. App. 318a (*PUC*) (Coral at $249/MWh for delivery in 2001 and 2002 and Sempra

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[9] Several briefs refer to findings in the Snohomish docket that the costs of forward contracts were supposedly not impacting ratepayers in any significant degree. *E.g.*, MSCG Br. 47. Again, such a finding was not outcome determinative as FERC ruled against Intervenors despite the 100% pass-through in California.

at $189/MWh for delivery between June 1, 2001 and September 30, 2001). Other contracts hid the high prices in long-term flat rates stretching out well beyond the period of expected continued price spikes. In such contracts, the price is levelized, such that one consistent price per megawatt-hour is charged over the life of the contract. To ensure the seller reaps the expected windfall from high, current forward prices, the levelized price is set to provide the seller the same total revenue as if the contract was priced to track the downwardly-sloping forward price curve. (*See, e.g.*, ER-401.) In this way, the levelized prices in contracts disguise the very high prices in the early years "much in the way that a level monthly mortgage payment disguises the fact that, in the early years, very little repayment of principal occurs." (ER-184.) Thus, while a seller of a ten-year contract could charge a lower nominal price by structuring its deal to recoup the expected high prices for 2001 and 2002 over the entire term of the ten-year deal, the seller in a nineteen-month deal would price the contract so as to recoup the same high prices over the much shorter contract duration. (*E.g.*, ER-401.) One way or another, the contract locked the buyer into paying the near-term forward prices that were inflated by the experience and expectations of continued inflated spot prices.

The Dynegy contract provides a good example of the windfall sellers seek to gain from these contracts. This contract called for CDWR to buy up to 1,500 MW of on-peak and off-peak energy from March 6, 2001

through December 31, 2004. (*See* ER-108.) At the time of contracting, Dynegy essentially locked in several hundred million dollars in profit, even if CDWR took only the minimum amount of power required under the contract. (Ex. CAL-172 (page 7 of 8, Row 47); Tr. 2114:17-20; Tr. 2116:16-19; Tr. 2117:8-11, 17-22; Tr. 2118:6-12.)[10] Dynegy's expected profits were so large that it anticipated recovering from just this three-plus year contract more than its total capital investment in *all* of its generating facilities in California, including one facility that is not even providing any power under the contract from this deal. (*See* Tr. 2153:17-19; Tr. 2134:22-25.)

None of the contracts at issue in either the CPUC or the Snohomish docket was ever filed for review or made effective pursuant to Section 205 of the FPA. 16 U.S.C. 824d(c)-(d).[11]

IV. THE PROCEEDINGS BELOW

Having previously found the Western spot markets dysfunctional,[12] FERC set for hearing in both the

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[10] The cited portions of the *PUC* record reflect Dynegy's precise profit expectations. Because this information was deemed confidential pursuant to a FERC-issued protective order, the referenced evidence was not included in the Excerpts of Record but was cited to the court below.

[11] The few contracts that were filed were not filed for Section 205 review. *See* discussion *infra* at Section II.A.

[12] *See generally* Nov. 1, 2000 Order, 93 FERC ¶61,121; J.A. 477a-671a (Dec. 15, 2000 Order).

Snohomish docket and the CPUC docket the question whether spot market dysfunction adversely affected prices in the forward markets. J.A. 1102a (Snohomish Order); J.A. 1146a (CPUC Order). FERC also set for hearing the issue whether a "public interest" or a "just and reasonable" standard of review should apply to the challenged contracts. J.A. 1100a (Snohomish Order); J.A. 1143a-45a (CPUC Order). In the Snohomish docket, both issues were decided initially by ALJ Cintron (Pet. App. 68a-245a); in the CPUC docket, FERC ordered ALJ McCartney to decide only the latter issue and then to refer the record to the Commission for decision on the merits under the relevant standard of review. J.A. 1385a-86a.

Concurrently, FERC staff found that anti-competitive conditions in the spot market undoubtedly did affect forward market prices, distorting the forward market up to 33%,[13] and FERC itself now concedes on appeal that spot market dysfunction affected forward prices. FERC Br. 44 ("To be sure, the dysfunction in the spot market had an effect on the prices available in the forward market."). Although FERC had set for hearing the question whether, as it now concedes, spot market dysfunction affected forward prices, FERC ruled the evidence of such effects irrelevant. *E.g.*, Pet. App. 320a-21a, 327a (*PUC*). FERC disregarded the issue of the impact of

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[13] *See* Supp. J.A. 199sa-200sa, 206sa (Staff Report); Nov. 1, 2000 Order, 93 FERC at 61,367 ("These higher spot market prices in turn affect the prices in forward markets.").

spot market dysfunction on forward prices based principally on its legal conclusion that the "just and reasonable" standard did not apply to these contract rate challenges: "a finding that the unjust and unreasonable spot market prices caused forward bilateral prices to be unjust and unreasonable would be relevant to contract modification only where there is a 'just and reasonable' standard of review." J.A. 1275a (Snohomish June 26, 2003 Order); J.A. 1346a (CPUC June 26, 2003 Order).

Based on its interpretation of *Mobile*[14] and *Sierra*,[15] FERC determined that it cannot modify a contract merely on the grounds that it is unjust and unreasonable; it must be shown that the rates, terms and conditions are contrary to the "public interest." J.A. 1274a-76a (Snohomish June 26, 2003 Order); J.A. 1345a-46a (CPUC June 26, 2003 Order). Under that standard, FERC held the contracts to have been "pre-determine[d]" to be just and reasonable by virtue of a prior grant of market-based rate authority to the sellers, J.A. 1564a, and held irrelevant the question whether the contracts were in fact unjust and unreasonable when signed due to the impact of spot market dysfunctions. J.A. 1228a-29a, 1275a-76a (Snohomish June 26, 2003 Order); J.A. 1329a-30a, 1346a (CPUC June 26, 2003 Order).

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[14] *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956).

[15] *FPC v. Sierra Pac. Power Co.*, 350 U.S. 348 (1956).

The court of appeals reversed FERC on this purely legal issue, ruling, correctly, that there is only a single statutory standard, the requirement that all rates be just and reasonable; that the existence of market dysfunction at the time of contract formation is relevant; and that FERC must consider this evidence in discharging its responsibility under the FPA to protect the public interest. Pet. App. 35a-42a (*PUD*); Pet. App. 316a, 324a (*PUC*). Moreover, regardless of whether the contracts provide that a "public interest" standard of review applies, that standard does not apply unless: (1) FERC determines that the challenged contracts were formed in circumstances free from market manipulation or other market dysfunction; and (2) FERC's regulatory regime allows sufficient initial review of contract rates. Pet. App. 35a-42a (*PUD*); Pet. App. 324a (*PUC*). Finally, protection of the public interest upon which the FPA is based does not allow rates to be borne by consumers to exceed the "zone of reasonableness." Pet. App. 60a-65a (*PUD*); Pet. App. 327a-29a (*PUC*).

SUMMARY OF ARGUMENT

Under the FPA, FERC is charged with the protection of consumers who ultimately bear the impact of wholesale rates. Toward that end, Congress "grant[ed] the Commission an opportunity in every case to judge the reasonableness of the rate." *Ark. La. Gas. Co. v. Hall*, 453 U.S. 571, 582 (1981) ("*Arkla*"). The FPA allows the public to trigger such review by

complaint, *see* 16 U.S.C. 824d(e), and accords "special solicitude" to parties like Intervenors to represent the public interest in such complaint proceedings. *See Md. People's Counsel*, 760 F.2d at 320-21.

Intervenors consistently have advanced a simple and basic argument: the FPA requires at least one opportunity for a determination whether the rates in the subject contracts were just and reasonable when the contracts were signed; and neither the signing of the contracts nor the *ex ante* grant of market-based rate authority to the sellers provides an adequate substitute for such an opportunity. As the court of appeals correctly held, FERC erred in ruling otherwise.

FERC's position has been highly inconsistent. It ruled below that the question whether contractual rates are unjustly and unreasonably high is simply "not . . . relevant." *E.g.*, J.A. 1534a (CPUC Nov. 10, 2003 Order); *see also* J.A. 1275a-76a (Snohomish June 26, 2003 Order); J.A. 1346a (CPUC June 26, 2003 Order). FERC now tries to disavow its stated reasoning below, conceding that all rates must be just and reasonable, as the statute commands. *See* FERC Br. 21 ("The court of appeals was correct to observe that 'there is but one statutory standard addressing the lawfulness of wholesale electricity rates' and '[t]hat standard requires that *all* rates be "just and reasonable."'") (quoting Pet. App. 35a (*PUD*)) (square brackets added by FERC) (emphasis in original court of appeals' opinion). In its brief, FERC now relies instead on a newly fashioned tautology, defining as "just and reasonable" any rate included in a contract,

at least unless the rate is so high as to exceed not merely the statutory "zone of reasonableness" but also some entirely undefined, alternative, and higher threshold. *See, e.g.*, FERC Br. 22-25.

FERC also held below that the issue whether the contract rates were unjust and unreasonable when signed is irrelevant because, when it granted sellers market-based rate authority, FERC made a "'blanket' just and reasonable determination which applies to subsequent market-based sales." J.A. 1564a (Snohomish Nov. 10, 2003 Order); J.A. 1504a (CPUC Nov. 10, 2003 Order). Thus, FERC first presumed that the discipline of a competitive market would render future rates just and reasonable, and then made this presumption irrefutable by declaring "not relevant" the findings of its own staff that the rates in question were substantially inflated by the non-competitive conditions in the markets at the time the contracts were signed. J.A. 1275a (Snohomish June 26, 2003 Order); J.A. 1346a (CPUC June 26, 2003 Order). Before this Court, FERC again abandons, at least partially, its position below, seeking to justify its presumption that market-based rates would be just and reasonable by pointing to monitoring and other precautions implemented long after these contracts were signed in markets that FERC concedes were neither adequately controlled by FERC nor competitive. *See* FERC Br. 29-32.

The selling and buying of electricity at wholesale is, for the most part, pursuant to contract. *See, e.g.*, *The Value of Independent Regional Grid Operators: A*

Report by the ISO/TRO Council at 24 (Nov. 2005) ("Most electricity transactions in North America occur through bilateral agreements, in which two market participants enter directly into a contract."). If accepted, FERC's position, whether as stated below or on appeal, would carve out this bulk of the electricity market from the fundamental statutory requirement that rates be just and reasonable. By contending in effect that the contract itself provides the only measure of the rate's reasonableness, FERC would turn on its head this Court's pronouncement in *FPC v. Texaco, Inc.*, 417 U.S. 380, 400 (1974), that "the Commission lacks the authority to place exclusive reliance on market prices." In this manner, FERC would effectively eliminate wholesale rate regulation as a practical protection for consumers against excessive pricing.

ARGUMENT

I. THERE MUST BE AT LEAST ONE OPPORTUNITY FOR A DETERMINATION WHETHER THE CHALLENGED CONTRACT RATES ARE JUST AND REASONABLE.

A. The Federal Power Act Requires An Opportunity In Every Case For A Determination Of The Justness And Reasonableness Of Rates.

FPA Section 201 sets forth the fundamental public policy rationale of the Act: the wholesale sale

of electricity for ultimate distribution to consumers "is affected with a public interest." 16 U.S.C. 824(a). Section 205(a) implements this basic policy by requiring that the rates in all wholesale contracts for sale of electricity be "just and reasonable." Rates that are not "just and reasonable" are "declared to be unlawful." *Id.* 824d(a); *see also id.* 824e(a). A "major purpose of the whole Act is to protect power customers against excessive prices." *Pa. Water & Power Co. v. FPC*, 343 U.S. 414, 418 (1952); *see also Atl. Ref. Co. v. Pub. Serv. Comm'n*, 360 U.S. 378, 388 (1959) ("The [NGA] was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges.").[16] There can therefore be "no doubt" that FERC's primary task in advancing the public interest in reasonable prices is "to guard the consumer from exploitation by non-competitive electric power companies." *NAACP v. FPC*, 520 F.2d 432, 438 (D.C. Cir. 1975); *see also Elec. Dist. No. 1 v. FERC*, 774 F.2d 490, 492-93 (D.C. Cir. 1985) (Scalia, J.) ("[T]he Federal Power Act's primary purpose [is] protecting the utility's customers.").

Section 205(c) seeks to ensure the protection of consumers against excessive rates by imposing, first, a mandate that utilities:

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[16] *Atlantic Refining* construes the Natural Gas Act, 15 U.S.C. 717-717z; this case involves the similar provisions of the FPA. This Court "cite[s] interchangeably decisions interpreting the pertinent sections of the two statutes." *Arkla*, 453 U.S. at 577 n.7.

> *shall file* with the Commission, within such time and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, *schedules showing all rates and charges for any transmission or sale* subject to the jurisdiction of the Commission . . . *together with all contracts* which in any manner affect or relate to such rates, charges, classifications, and services.

16 U.S.C. 824d(c) (emphasis added). Under FERC regulations, rates filed under Section 205(c) must be filed at least sixty days in advance of their becoming legally effective. 18 C.F.R. 35.3(a); *see also id.* 35.2(e) ("The effective date shall be 60 days after the filing date, or such other date as may be specified by the Commission."). Section 205(d), in turn, prescribes the process for making changes to rates previously established under Section 205(c). Sellers must file and post for public inspection "new schedules stating plainly the changes" sixty days prior to the time new rates take effect. 16 U.S.C. 824d(d); *see also* 18 C.F.R. 35.3(a).

There is an "indissoluble unity" between the filing requirement and the requirement that rates be "just and reasonable." *MCI Telecomms. Corp. v. AT&T Co.*, 512 U.S. 218, 230 (1994) (quoting *Tex. & Pac. R. Co. v. Abilene Cotton Oil Co.*, 204 U.S. 426, 440 (1907)); *see also MCI*, 512 U.S. at 230 ("this Court has repeatedly stressed that rate filing was Congress's chosen means of preventing unreasonableness and discrimination in charges"); *Mobile*, 350 U.S. at 339

(although relations of the parties may be established initially by contract, "the protection of the public interest [is] afforded by supervision of the individual contracts, which to that end must be filed with the Commission and made public.").

Under the FPA, the issue whether an agreed-upon rate is just and reasonable is to be determined by FERC, not by the parties to an agreement, "however voluntary their agreement may be." *Pa. Elec. Co. v. FERC*, 11 F.3d 207, 210 (D.C. Cir. 1993) (citing *Tejas Power Co. v. FERC*, 908 F.2d 998, 1003 (D.C. Cir. 1990)). Moreover, the prevailing price in the marketplace is not the final measure of just-and-reasonable rates: "Congress rejected the identity between the 'true' and 'actual' market price . . . [and] the Commission lacks the authority to place exclusive reliance on market prices." *Texaco*, 417 U.S. at 399-400.[17] This Court consistently has held that regulatory agencies cannot delegate their responsibility to ensure the justness and reasonableness of rates to market participants and their private agreements.

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[17] *See also FPC v. Sunray DX Oil Co.*, 391 U.S. 9, 25-26 (1968); *Interstate Natural Gas Ass'n v. FERC*, 285 F.3d 18, 30-31 (D.C. Cir. 2002) ("*INGAA*"); *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870 (D.C. Cir. 1993); *Farmers Union Cent. Exch. v. FERC*, 734 F.2d 1486, 1508-09 (D.C. Cir. 1984); *MacDonald v. FPC*, 505 F.2d 355, 364 (D.C. Cir. 1974); *Shell Oil Co. v. FPC*, 520 F.2d 1061, 1084 (5th Cir. 1975); *cf. Mobil Oil Corp. v. FPC*, 417 U.S. 283, 312-13 (1974) (admission into the agency record of agreement among some parties "did not, of course, establish without more the justness and reasonableness of its terms.").

MCI, 512 U.S. at 231, 234 ("[r]ate filings are . . . the essential characteristic of a rate-regulated industry"; "'the Commission's desire to "increase competition" cannot provide [it] authority to alter the well-established statutory filed rate requirements'") (quoting *Maislin Indus., U.S., Inc. v. Primary Steel, Inc.*, 497 U.S. 116, 135 (1990)); *see also Cal. ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1014 (9th Cir. 2004), *cert. denied*, 127 S. Ct. 2972 (2007) ("*Lockyer*"). Rather, the Court has insisted that "the clear purpose of the congressional scheme" of rate filing is to "grant[ ] the Commission an opportunity in every case to judge the reasonableness of the rate." *Arkla*, 453 U.S. at 582. FERC purportedly agrees that it must provide, in all cases, at least some form of review that ensures that rates will be just and reasonable. *See* FERC Br. 27-30, and 7 ("The Commission's review is designed to ensure that sellers cannot exercise market power and thus the rates charged are just and reasonable.").

Toward this end, FERC has authority under Section 205(e) to accept the rate or suspend its operation for a period not to exceed five months pending an investigation "concerning the lawfulness of such rate, charge, classification, or service." 16 U.S.C. 824d(e). Such an investigation can be initiated by the Commission on its own motion or upon the challenge of a third party. *Id.* In a Section 205 proceeding, the burden is on the contracting party to prove the rate is just and reasonable, and any excessive rate collected

during the pendency of the investigation can be subject to refund. *Id.*

New rates go into effect by operation of law at the close of the suspension period, but if FERC has not completed its investigation, it may allow the new rate to take effect subject to refund. *Id.* Further, third parties have a period of twenty-one days after the rate filing to protest the filing of a new rate. 18 C.F.R. 35.8(a). Absent challenge by FERC or a third party, rates take effect sixty days after their filing. *Id.* 35.2(e).

Thereafter, an existing rate can be challenged as unjust and unreasonable under Section 206 of the FPA, and if FERC determines by hearing "that any rate . . . charged . . . or that any . . . contract affecting such rate . . . is unjust [or] unreasonable . . . , the Commission shall determine the just and reasonable rate . . . or contract to be thereafter observed and in force, and shall fix the same by order." 16 U.S.C. 824e(a). In a Section 206 proceeding, the burden is on the party challenging a contract to prove that the rate is unjust and unreasonable, and only prospective relief can be granted. *Id.* 824e(b).

The FPA thus envisions and requires at least one opportunity for FERC to assess whether *any* jurisdictional rate, whether set by contract or otherwise, satisfies the bedrock requirement that such rates be just and reasonable. The text of the statute is clear: it requires that *all* rates be filed, and that *all* rates be just and reasonable, and makes no exception for

rates set by contract. Further, this Court has made it eminently clear that the filing requirement was Congress's chosen means of enforcing the substantive just-and-reasonable requirement as to all rates, by giving both FERC and the public an opportunity to challenge, either on complaint or the agency's own motion, the legality of rates.

B. This Court Has Not Held That The Signing Of A Contract Obviates The Need For An Opportunity To Determine Whether The Contract Will Burden Consumers With Excessive Rates.

In *Mobile* and *Sierra*, the Supreme Court considered the following scenarios: A private seller and a private buyer entered into a contract for the purchase and sale of gas (*Mobile*) and power (*Sierra*) for a period of time at specified rates; the sellers filed their contracts with FERC, and the rates thereupon became effective in the absence of any challenge. In those cases, the requirement of an opportunity for initial review of rates was satisfied by contract filing. *See Mobile,* 350 U.S. at 336-37; *Sierra,* 350 U.S. at 350-52. At a later date, the sellers sought to raise the rates, due to changes occurring after the contracts were filed, over the objection of the buyers. *See Mobile,* 350 U.S. at 335-38; *Sierra,* 350 U.S. at 351-53. Those facts distinguish *Mobile* and *Sierra* from these cases, where no opportunity to challenge the rates as unjust and unreasonable had previously been given to the complainants, and where the claim is that the

rates were excessive when the contracts were signed.[18] Arguments to the contrary misperceive the role of contract stability, ignore the Court's express admonition that burdening the public with excessive rates is against the public interest, and fashion a notion of "symmetry" incompatible with the FPA and its principal purpose.

1. Petitioners' purported defense of "contract stability" exaggerates the extent of regulatory review at issue here, and ignores the fact that Congress sought to ensure that there be such a review.

Petitioners and FERC rest much of their argument upon an assumption that any review of rates set by contract is incompatible with notions of "contract

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[18] In an attempt to argue that the lack of a prior opportunity for review does not impact the application of *Mobile* and *Sierra*, Petitioners cite cases that have held that a party that shirks its own obligation to file its rate cannot later claim the benefit of the breach of its statutory duty by using the failure to file as the basis for avoiding enforcement of the contractual rate. *See, e.g.*, Calp. Br. 40 n.7 (citing *Sam Rayburn Dam Elec. Coop. v. FPC*, 515 F.2d 998, 1008 (D.C. Cir. 1975); *Borough of Lansdale v. FPC*, 494 F.2d 1104, 1112 (D.C. Cir. 1974); *Natural Gas Pipeline Co. of Am. v. Harrington*, 246 F.2d 915, 919 (5th Cir. 1957)). That principle hardly helps Petitioners here. In any case, those cases certainly do not stand for the proposition Petitioners imply: namely, that *Mobile-Sierra* precludes any initial review of a particular contract rate to determine whether it is just and reasonable.

stability." *See, e.g.*, FERC Br. 17; MSCG Br. 25-27; Calp. Br. 33. This argument is twice flawed: It exaggerates the extent of the review at issue here, and it ignores Congress's decision that such review would itself provide a source of stability in securing reasonable prices and adequate supply.

First, Intervenors do not argue that valid contracts previously reviewed or subject to review can be later set aside merely because the agreed-upon contract rates later turn out to be higher than spot market rates. A forward contract allocates risk of future volatility, with the seller accepting the risk that rates might later rise, and the buyer accepting the risk that rates might later fall. Intervenors' contention is that such a contract need be just and reasonable at the time made. If, as here, the contracts when made are the product of market dysfunction as sellers lock in non-competitive prices well into the future, they should be set aside as unjust and unreasonable, just as they would be set aside if infected with other types of infirmities in their formation. Conversely, if the contract is just and reasonable when made, then the fact that later developments show the buyer – or seller – would have in fact been better off without the contract provides no basis by itself for rescinding or revisiting the deal.

Second, this Court has never suggested that "contract stability" trumped even the opportunity to determine whether the contract when made would unjustly and unreasonably burden consumers. To the contrary, as this Court itself has recognized, private

contracts do not preempt regulatory review as a source of price and supply stability:

> The short of the matter is that *Mobile* recognized that there were two sources of price and supply stability inherent in the regulatory system established by the Natural Gas Act – the provisions of private contracts and the public regulatory power. *See* 350 U.S. at 344. Petitioner now urges an application of that decision that could make private contracts the only stabilizing factor under the Act. Not only does this reading have nothing to do with the integrity of private contracts which *Mobile* underwrote, but it makes a severe incursion into the sources of that stability of natural-gas prices and supply to which that decision gave confirmation.

Sunray Mid-Continent Oil Co. v. FPC, 364 U.S. 137, 155-56 (1960); *see also Middle South Energy Co. v. FERC*, 747 F.2d 763, 776 n.4 (D.C. Cir. 1984) (Ginsburg, J., dissenting) ("Petitioner's 'contract autonomy/*Mobile*' argument distorts precedent to no avail. . . . FERC already has the power to alter initial rates set by contract as soon as it determines that the rates are unreasonable.").

2. Petitioners also overlook the Court's recognition that FERC's charge is to protect the public from excessive rates.

Mobile and *Sierra* make clear that the aim of the FPA is not to protect private contracting parties, *per se*. Rather, "the purpose of the power given the Commission by § 206(a) is the protection of the public interest, as distinguished from the private interests of the utilities. . . ." *Sierra*, 350 U.S. at 355. Thus, even though interested parties had an opportunity to challenge the rates upon filing, and even though the contracting parties sought to change rates based on after-occurring events, the Court noted that FERC retains full authority to review any and all wholesale power contracts and to modify them where the rate has become unlawful, for example, in a "low-rate" case by "cast[ing] upon other consumers an excessive burden." *Sierra*, 350 U.S. at 355; *see also Mobile*, 350 U.S. at 344 ("the contracts remain fully subject to the paramount power of the Commission to modify them when necessary in the public interest."). In short, at the same time that the Court found that principles of contract stability trump the private interests of sellers who wish to raise rates after a contract has been filed and its rates subject to review and challenge, the Court also affirmed FERC's fundamental statutory charge to protect consumers from excessive rates.

3. Modification of an agreed-upon rate to protect the public from unjust and unreasonable prices does not violate any statutory "symmetry."

FERC and Petitioners claim that permitting the public to challenge contract rates as excessively high creates an impermissible lack of symmetry. *See, e.g.*, FERC Br. 40; Calp. Br. 31, 53-54. Under their view, the Court in *Mobile* and *Sierra* was attempting to preclude regulation of contract rates – whether too low to the detriment of sellers or too high to the detriment of consumers.

The simple answer to this proffered interpretation of *Mobile* and *Sierra* was provided by the Commission and the Solicitor General immediately in the wake of *Mobile* and *Sierra* when addressing the first "high rate" challenge to a contract:

> It is evident, as the Commission and the unanimous court below recognized, that this Court was not attempting to prevent regulation of contract rates, as petitioner contends, but was only protecting consumer interests and that the *Sierra* holding can have no application where, as here, the contract rates are found unjust and unreasonable – because excessive – and consequently an unwarranted burden on the ultimate consumer.

S.C. Generating Co. v. FPC, Docket No. 57-697, Brief of the Federal Power Commission in Opposition to Petition for Certiorari (Feb. 13, 1958); *see also Watt v. Alaska*, 451 U.S. 259, 272-73 (1981) ("The

Department's contemporaneous construction carries persuasive weight. . . . The Department's current interpretation, being in conflict with its initial position, is entitled to considerably less deference.").

In opposing the grant of certiorari in this very case several months ago, the Commission adhered to its 1958, contemporaneous application of *Mobile-Sierra* to high rate cases by defending the ruling of the court of appeals: "Nor did the court [of appeals] create a rule that is biased against sellers. In many of the portions of its opinion cited by petitioners, the court was simply observing that the factual considerations in low-rate and high-rate cases differ, a point that is neither surprising nor new." FERC Opp. Br. 21.

If there is any asymmetry in the application of *Mobile* and *Sierra*, it flows from the Act and from the different impact on the public that a party's agreement has on the low end and the high end of the statutory zone of reasonableness.[19] At the low end, rates cannot be confiscatory; at the high end, they

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[19] This Court's reference in *Permian Basin Area Rate Cases*, 390 U.S. 747, 822 (1966) to "unequivocal public necessity" reflects the Act's asymmetry, as the Court invoked that notion in the portion of its opinion dealing with sellers' complaints about aggregate revenue deficiencies due to "bargains previously obtained" by some contractual buyers, *id.* at 822, but did not in general require such "unequivocal public necessity" to allow "abrogation of contract prices above" the maximum area rates the Commission had set. *Id.* at 818.

cannot impose an excessive burden on consumers. *See FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944)); *INGAA*, 285 F.3d at 31 ("zone of reasonableness" is a range of rates that are considered "just and reasonable" because they "are neither less than compensatory nor excessive") (citations omitted).

Because the low end of that zone is a constitutional minimum – the level at which a rate would confiscate utility property, *see FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 585-86 (1942) – consent has the power to move that lower limit. Hence the Court observed in *Sierra* that a consensual rate can be lawful even if the Commission could not impose it. *See Sierra*, 350 U.S. at 355. The same cannot be said of a party's consent to a rate that exceeds the high end of the zone of reasonableness. *See Elec. Dist. No. 1*, 774 F.2d at 492-93; *NAACP*, 520 F.2d at 438. A contract rate that falls outside the high end of the spectrum is an unjust and unreasonable burden on the public whether derived through contract or imposed otherwise, and is therefore unlawful. *Texaco*, 417 U.S. at 399 (the NGA and FPA "make[ ] unlawful all rates which are not just and reasonable"; not even "a little unlawfulness is permitted."). Accordingly, while a seller's consent to a rate below the constitutional minimum suffices to convert the rate into a permissible rate under the FPA (and the Constitution), it does not follow that voluntary agreement has the same transformative power for a rate above the zone of reasonableness, at least when such a rate is borne by the consuming public, as it is in these cases.

The FPA imposes a limit for rates at the high end, and that limit cannot be contracted away.[20]

C. This Court In *Verizon* Did Not Eliminate FERC's Obligation To Ensure That Consumers Are Not Burdened With Excessive Rates.

Petitioners argue that *Verizon Communications, Inc. v. FCC*, 535 U.S. 467 (2002), supports their interpretation of *Mobile* and *Sierra*, focusing on the Court's statements at pages 479 and 480 that: (1) "sophisticated businesses enjoying presumptively equal bargaining power" might be expected to negotiate a rate that is just and reasonable "as between the two of them"; and (2) a federal regulator may not undo an "improvident bargain" for one of the contracting parties. *See, e.g.*, MSCG Br. 30-31.

Petitioners misread *Verizon*, which involves the rate-setting powers of the Federal Communications Commission under the Telecommunications Act of 1996. The very language itself in *Verizon* ("presumptively equal bargaining power") assumes a competitive

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[20] Far from establishing that *Mobile* or *Sierra* allows private parties to waive the public's interest in just-and-reasonable rates, the D.C. Circuit's decision in *Papago Tribal Utility Authority v. FERC*, 723 F.2d 950 (D.C. Cir. 1983) (Scalia, J.), rightly observes that private parties can waive their own interest in rates at a certain level, but that their right to agree to any rate ends where adverse impact on the public begins. *Id.* at 953 n.4.

market in which no party is able to benefit from the exercise of market power. Such a presumption hardly supports what Petitioners seek: an irrefutable presumption that all markets, including those that are anti-competitive, will produce just and reasonable rates in all contracts. As this Court has clearly stated, *Mobile* and *Sierra* do not in any way "affect the supremacy of the [FPA] itself." *Arkla*, 453 U.S. at 582.

Such a presumption as urged by Petitioners would be incompatible with the very existence of the FPA itself, which it is "abundantly clear" was enacted precisely because Congress concluded that forces "distorting the market price" necessitated regulation.

> [I]f contract prices for gas were set at the market price, this "would necessarily be based on a belief that the current contract prices in an area approximate closely the 'true' market price – the just and reasonable rate. Although there is doubtless some relationship, and some economists have urged that it is intimate, such a belief would contradict the basic assumption that has caused natural gas production to be subjected to regulation."

Texaco, 417 U.S. at 398 (quoting *Sunray DX Oil Co.*, 391 U.S. at 25 (footnote omitted)). *Cf. FPC v. Conway Corp.*, 426 U.S. 271, 279 (1999) (referencing FERC's "duty" to consider whether a proposed rate will have anti-competitive effects. The exercise by FERC of powers otherwise within its jurisdiction "'clearly

carries with it the responsibility to consider in appropriate circumstances, the anticompetitive effects of regulated aspects of interstate utility operations pursuant to . . . directives contained in §§ 205, 206. . . .'") (quoting *Gulf States Util. Co. v. FPC*, 411 U.S. 747, 758-59 (1973)). Accordingly, market dysfunction cannot be irrelevant under the FPA, as FERC now concedes, and there is no rationale upon which to presume the justness and reasonableness of a market rate, *i.e.*, a contract rate, from voluntariness alone. Indeed, the very concept of "voluntariness" is of little utility in assessing agreements entered into under the conditions of extreme public emergency that led to CDWR's purchases.[21]

Further, from a broader policy perspective, Petitioners' view that privately contracting wholesale purchasers in pursuit of their own private interests will necessarily protect consumers ignores the fact that the preemptive force of the FPA often means that private utilities may simply pass on their wholesale power procurement costs to retail customers. *See, e.g.*,

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[21] Similarly, it makes little sense to suggest, as Petitioners do, *see, e.g.*, MSCG Br. 32-33; Calp. Br. 31, that parties who purchased under such extreme circumstances that they were forced to agree to unjust and unreasonable rates and conditions must nonetheless be held to a purportedly voluntary waiver of their Section 206 rights to challenge those rates. *See, e.g., Tejas*, 908 F.2d at 1004 ("This is not entirely logical: if the pipeline has significant market power with which to extract an agreement unfavorable to its LDC customers, then it would not require much imagination for the pipeline also to require that they support the agreement fully before the Commission.").

Nantahala Power & Light v. Thornburgh, 476 U.S. 953, 970 (1986). One cannot simply presume, as Petitioners do, that wholesale purchasers necessarily have interests that are aligned with the interests the FPA is intended to protect. As this Court aptly acknowledged in *Verizon*, *Sierra* draws a distinction between rates that are just and reasonable "as between the two [wholesale businesses]" and rates that are "'just and reasonable' to the public." *Verizon*, 535 U.S. at 479, 480. Precisely because protection of the public cannot be presumed merely from a private purchaser's agreement, the FPA requires the filing of all contracts, and gives both FERC and the public an opportunity to challenge the legality of all rates set by contract.

As a matter of history, the Court's many prior holdings that Congress regulated because it considered the marketplace insufficient protection against unjust and unreasonable rates are correct, and the allowance under the FPA for rates to be set by contract implies no congressional reliance on private contracts to protect the public. At the time the FPA was enacted, the parties that would be executing and filing contracts under the FPA were vertically integrated monopolies – for example, neighboring monopolies agreeing to wheel power through one another's territory. *See Otter Tail Power Co. v. United States*, 410 U.S. 366, 374 (1973) (citing S. Rep. No. 621 (1935)). Not only would there be no reason to assume such monopoly-to-monopoly contracts would result in just-and-reasonable rates, Congress's

requirement that all such contracts be filed reserves judgment about their justness and reasonableness. *Cf. Tejas*, 908 F.2d at 1004. Congress's allowance of the filing of individually negotiated contracts in the FPA context reflects no more than a recognition that the nature of the contracts being executed in the power field made it administratively feasible to file and review individual service contracts in a way that was not feasible to do in the common carrier arena. *See Mobile*, 350 U.S. at 338-39.

Petitioners' argument that allowing FERC to review the justness and reasonableness of contractual rates would be poor policy is thus an argument for Congress, and one that Congress has rejected. Moreover, Petitioners' claim that the prospect of such review runs havoc with efficient and low-price contracting is unsupported by experience. It has long been FERC's position that *Mobile* and *Sierra* do not insulate contract rates from challenge and review should the rates be excessive. *See S.C. Generating Co. v. FPC*, Docket No. 57-697, Brief of the Federal Power Commission in Opposition (Feb. 13, 1958), discussed *supra* at Section I.B.3. As FERC confirmed in opposing the grant of certiorari in this proceeding, there has been no flood of contract challenges in the wake of the court of appeals' decision, and FERC has been able to efficiently deal with any challenges that have been filed. *See* FERC Opp. Br. 12 ("there have been relatively few complaints, and, more important, the Commission has promptly rejected those that lack

merit."). And, if Petitioners were correct that sellers would build in large risk premiums should subsequent review be possible, then the contracts at issue here would presumably contain such charges, given that FERC actually did say in 2000 that it would review these contracts for their justness and reasonableness. *See* J.A. 520a (Dec. 15, 2000 Order).

If the mere existence of a contract insulated rates from review for justness and reasonableness, the agency would become superfluous, and the provisions in the FPA requiring FERC to ensure the justness and reasonableness of rates would be rendered meaningless. Petitioners suggest that FERC still would be able to set aside contracts infected with fraud or duress in their formation. *See, e.g.*, Calp. Br. at 42, 55. Such infirmities in contract formation, however, can be addressed through existing remedies between the contracting parties, outside regulation. There would be no need to enact Sections 205 and 206 of the FPA unless the intent was to charge FERC with doing more than merely policing the common-law requirements for valid contract formation.

II. FERC DID AWAY WITH ANY OPPORTUNITY FOR A DETERMINATION WHETHER THE CHALLENGED CONTRACT RATES ARE JUST AND REASONABLE.

The court of appeals correctly held that FERC erred when it provided no opportunity for review of

the justness and reasonableness of the challenged contract rates prior to their taking effect and no opportunity for such review in the proceedings below.

A. FERC Entirely Eliminated Any Opportunity To Judge The Justness And Reasonableness Of The Challenged Rates Under Section 205.

By the time of the Western energy crisis, FERC had entirely eliminated the opportunity to review the contracts under FPA Section 205. Most sellers simply did not file their contracts, so that neither FERC nor the public had any opportunity to review the specific rates, terms and conditions of those contracts before they took effect, under the just-and-reasonable or any other standard. *See, e.g.*, MSCG Br. 23-24 (acknowledging that MSCG did not file its contract with FERC). Rather than filing the contracts with FERC for review, wholesalers submitted an initial application to demonstrate that they lacked market power. *See Enron Power Enter. Corp.*, 52 FERC ¶61,193 at 61,711 (1990). If FERC agreed and approved the application, the seller could then begin to enter transactions charging whatever rates the market would bear. *Id.* FERC required only that the seller subsequently submit "informational" reports, on a quarterly basis, which summarized the market-based transactions it had already completed. *Lockyer*, 383 F.3d at 1013.

When a seller did file its contract with CDWR (albeit requesting waiver of the sixty-day filing requirement and that the contract be deemed retroactively effective), CPUC filed a challenge asking FERC to set the matter for hearing to determine whether the contract was just and reasonable. *GWF Energy, LLC*, 97 FERC ¶61,297 at 62,390 (2001). FERC expressly held that contract filings were "informational" only, and on that basis, rejected CPUC's Section 205 challenge and said the only way CPUC could obtain review of a CDWR long-term contract would be for it to file a Section 206 complaint. *See id.* at 62,390-91 ("long-term power sales agreements entered into pursuant to previously-granted market-based rate authority . . . are not traditional Federal Power Act (FPA) section 205 filings, but rather are informational filings"), 62,391 ("[T]he filing of such agreements does not serve as a vehicle to challenge the justness and reasonableness of either the agreements themselves or the underlying market-based rate authority. . . . Because GWF entered into the Agreement pursuant to market-based rate authority previously granted by the Commission, the appropriate forum for [CPUC] to raise its concerns is in a complaint filed under FPA section 206.").[22]

In sum, it is undisputed that there never was any prior opportunity to review the justness and reasonableness of any of these specific contracts under Section 205.

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[22] Dynegy, too, made such a purely "informational" filing.

B. FERC Provided No Opportunity In The Section 206 Proceedings Below To Judge The Justness And Reasonableness Of The Challenged Rates.

Intervenors heeded FERC's direction through the present Section 206 complaints. However, FERC could not have been more express in its pronouncements that it would not and did not in these proceedings review the challenged contracts to determine, one way or the other, whether their rates were just and reasonable.

> Once a party signs a *Mobile-Sierra* contract, it cannot escape by later claiming that the rates were not just and reasonable when it signed the contract, unless there is evidence such as the seller fraudulently inducing the buyer to execute the contract.
>
> The Commission has already concluded that the California ISO and PX spot markets were dysfunctional during the relevant period and that rates in those markets were unjust and unreasonable. . . . [A] finding that the unjust and unreasonable spot market prices caused forward bilateral prices to be unjust and unreasonable would be relevant to contract modification only where there is a "just and reasonable" standard of review. . . . Under the "public interest" standard, to justify contract modification it is not enough to show that forward prices became unjust and unreasonable due to the impact of spot market dysfunctions; it must be shown that the

> rates, terms and conditions are contrary to the public interest.

J.A. 1564a (Snohomish Nov. 10, 2003 Order); J.A. 1503a (CPUC Nov. 10, 2003 Order); J.A. 1275a-76a (Snohomish June 26, 2003 Order); J.A. 1346a (CPUC June 26, 2003 Order).

Finding that the challenged contracts did not contain *Memphis*[23] clauses, FERC held that the statutory "just and reasonable" standard did not apply. J.A. 1275a (Snohomish June 26, 2003 Order); J.A. 1346a (CPUC June 26, 2003 Order). Under the stricter "public interest" standard that FERC imposed, it held that the allegation that the contract rates were unjust and unreasonable from the very day they were signed simply was not relevant. *See* J.A. 1274a-76a (Snohomish June 26, 2003 Order); J.A. 1354a-59a (CPUC June 26, 2003 Order).

Even Sellers recognized the depth of FERC's error, and on rehearing sought clarification from FERC that the FPA does not allow any rates that are unjust and unreasonable. *See* J.A. 1567a (Snohomish Nov. 10, 2003 Order); J.A. 1506a (CPUC Nov. 10, 2003 Order). FERC persisted in its error, responding that its grant of market-based rate authority was a pre-execution determination that all of an authorized seller's subsequent contracts would be just and reasonable; on the issue whether the contracts were

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[23] *United Gas Pipe Line Co. v. Memphis Light, Gas & Water Div.*, 358 U.S. 103 (1958).

in fact just and reasonable when they were signed, FERC stated "[t]o the extent [Sellers'] request for clarification asks the Commission to opine on matters not before us in this case, we decline to do so." J.A. 1567a (Snohomish Nov. 10, 2003 Order); J.A. 1507a (CPUC Nov. 10, 2003 Order).

III. THE GRANT OF MARKET-BASED RATE AUTHORITY IS NOT A SUBSTITUTE FOR AN OPPORTUNITY FOR THE DETERMINATION OF THE JUSTNESS AND REASONABLENESS OF THE CHALLENGED RATES AT THE TIME OF CONTRACTING.

As noted in Section I.A, *supra*, FERC does not appear to dispute that the FPA in all cases requires the review of the justness and reasonableness of contractual rates. Instead, FERC argues that the procedures for granting market-based rate authority, and subsequent "monitoring" of the markets, were a form of "review" designed by FERC within its discretion to ensure "that the rates charged are just and reasonable." FERC Br. 7.

As an initial matter, all parties agree that this case does not present the general question whether a market-based rate regime can ever comply with the FPA, and solely because the question is not presented in this case, it is correct that "no party to this case disputes" that question. Calp. Br. 38. The fact remains, however, that this Court has never answered the question whether FERC's market-based rate regime could pass muster under the FPA, and clearly

the Court's denial of certiorari in *Lockyer* is not a determination of the merits of that question. *See, e.g., Knight v. Florida*, 528 U.S. 990, 990 (1999) (Stevens, J., respecting denial of certiorari) (denial of "[petitions for certiorari] does not constitute a ruling on the merits").

This case does, however, squarely present the question whether FERC can rely on the *ex ante* grant of market-based rate authority to the sellers as a substitute for determining whether these contract rates are just and reasonable. In answering this question, the court of appeals correctly held that: (1) there is no necessary nexus between the *ex ante* grant of market-based rate authority and the justness and reasonableness of a later-signed contract; (2) in the proceedings below, there was no opportunity to judge the existence of such a nexus; and (3) during the Western energy crisis, FERC's market monitoring did not provide any assurance of, or opportunity to challenge, the existence of such a nexus. Pet. App. 46a-60a (*PUD*); Pet. App. 324a-27a (*PUC*). Under those circumstances, the court of appeals correctly held that FERC did not fulfill the statutory mandate that there be an opportunity in every case to determine the justness and reasonableness of contracts. Pet. App. 38a-42a (*PUD*); Pet. App. 324a (*PUC*); *cf. Arkla*, 453 U.S. at 582.

A. Because The Grant Of Market-Based Rate Authority Entails No Consideration Of Market Conditions At The Time Of Contracting, There Is No Necessary Nexus Between The *Ex Ante* Grant Of Market-Based Rate Authority And The Justness And Reasonableness Of A Later-Signed Contract.

FERC grants market-based rate authority to a seller based on the seller's showing that, as of the time of the application, it lacks market power or has adequately mitigated its market power, and conditioned upon the seller's compliance with informational filing requirements and further triennial review of its market power. *See Lockyer*, 383 F.3d at 1013. FERC's "'blanket' just and reasonable determination" of future market-based sales is predicated on an assumption, based on a seller's current lack of market power, that the seller's prices in the future will fall within a zone of reasonableness. J.A. 1566a (Snohomish Nov. 10, 2003 Order); J.A. 1505a (CPUC Nov. 10, 2003 Order). In other words, the grant of market-based authority does not determine the justness and reasonableness of a subsequently executed contract; at most, it predicts it. The crucial assumption underlying such a predetermination of justness and reasonableness, therefore, is the assumption that competitive conditions will exist at the time of future contract execution. Of necessity, FERC's "blanket determination" does not and cannot

ensure that such conditions will exist at the time of contract execution, which may be long in the future.[24] FERC concedes as much: "any initial determination of [a rate's] justness and reasonableness can only be based on the factual circumstances existing at the time, and those circumstances can change." FERC Br. 34.

The notion that past predictions of reasonableness cannot preclude actual assessments of reasonableness at the time of contracting is hardly new. The filing requirement and opportunity for review of the application of a rate in practice lie at the very heart of the Act. *See MCI,* 512 U.S. at 231; *Maislin*, 497 U.S. at 135; *Arkla*, 453 U.S. at 582. Even in a classic tariff-filing situation, there must be an opportunity to judge whether the assumptions underlying approval of the tariff hold true at the time of imposition of the tariff rate on a new customer. *See, e.g.*, *Mun. Elec. Util. Ass'n v. FERC*, 485 F.2d 967 (D.C. Cir. 1973) ("*MEUA*"). In *MEUA*, a utility sought approval of a tariff to replace numerous customer-specific contracts upon the expiration of those contracts, in some cases several years in the future. *Id.* at 969. The court held that FERC was free to approve the tariff under

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[24] For example, three of the four remaining sellers in the CPUC docket received initial market-based rate authority in 1994, 1995, and 1996, respectively. *See* Letter Order, FERC Docket No. ER 94-968-000 (Apr. 7, 1994) (now Dynegy); Letter Order, FERC Docket No. ER 96-25-000 (Dec. 6, 1995) (Coral Power LLC); *PacifiCorp Power Mktg., Inc.*, 74 FERC ¶61,139 (Feb. 14, 1996).

Section 205, but that FERC had to give affected buyers a "renewed opportunity" to challenge the tariff *under Section 205*, at the time the utility sought to impose it on them. *Id.* at 974. The court noted that the FPA requires sellers to "shoulder a realistic burden of demonstrating [the tariff's] lawfulness, not in some theoretical sense but as it practically affects the parties at the time it is sought to be imposed." *Id.* The court noted that the buyer's right to bring a Section 206 challenge was not an adequate substitute for a renewed opportunity for Section 205 review. *Id.* ("Not only would the customer bear the heavy burden of showing the tariff had become unlawful in the period since its approval, but the cost and uncertainty of such proceedings makes recourse to them problematical."). "[O]pportunity must be given the customers . . . to call on the utility to show that the assumptions underlying the FPC's earlier determination of the tariff's lawfulness have been validated by experience." *Id.* Simply put, the opportunity for a Section 205 review of the rate at the time it is to become effective as to a particular buyer is "the minimum necessary to assure protection of the statutory rights of . . . customers" under the FPA. *Id.* at 976.

B. A Determination That Forward Markets Are Functioning Is No Substitute For A Determination Of The Justness And Reasonableness Of Rates, Especially When The Spot Markets Are Dysfunctional.

In the proceedings below, although FERC had specifically set the issue for hearing, FERC deemed the existence of spot market dysfunction and its impact on forward prices at the time of contracting "not . . . relevant." *E.g.*, 1534a (CPUC Nov. 10, 2003 Order).[25] FERC and Petitioners therefore cannot contend that the proceedings below provided any opportunity to determine whether the rates in the challenged contracts were inflated as a result of what FERC admits were non-competitive conditions in the spot market at the time of contracting. Instead, Petitioners and FERC make the much more limited observation that the forward markets themselves were "functional," *i.e.*, there was no finding of independent dysfunction or manipulation in the forward markets. *See* FERC Br. 44; Calp. Br. 44.

This limited observation is plainly insufficient to establish the rates in the contracts were not influenced

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[25] In the CPUC docket, FERC prohibited discovery of and excluded evidence concerning challenged sellers' market power, as well as evidence of the impact of acknowledged market dysfunction on market participants' expectations for future prices, which expectations principally drive forward prices. *See* Pet. App. 326a-27a (*PUC*).

by the lack of competitive conditions in the spot markets. FERC itself agrees. *See* FERC Br. 44 ("To be sure, the dysfunction in the spot market had an effect on the prices available in the forward market."). Forward prices are principally driven by expected future spot prices, regardless of the expected future cause of those future prices. If market participants expect future spot prices to be high, whether due to fundamental supply and demand or due to market dysfunction, then forward prices will be high as a result. *See, e.g.*, MSCG Br. 38 ("[P]rices in a forward market inevitably turn in some measure on expectations about future prices in the underlying spot market."); (ER-244 (Sempra witness Niggli) ("The current forwards are generally reflecting spot prices in the future.").)[26] One of the notable findings in the Staff Report was the statistically proven impact of *current* spot prices on forward prices: in other words,

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[26] FERC recognizes that spot markets function to exercise discipline on forward markets and prevent "excessive, non-competitive prices" in those markets. In denying requests for rehearing of its June 19, 2001 price mitigation order, FERC acknowledged that "[a]pplying mitigation to spot market transactions results in mitigation of generation market power in forward markets. . . . If sellers attempt to charge excessive, non-competitive prices in forward markets, customers can avoid them by waiting to purchase in the real-time market. This puts market pressure on sellers to offer competitive prices in the forward markets." J.A. 1021a (Dec. 19, 2001 Order). Where the spot markets are dysfunctional and prices there are unjust and unreasonable, resort to those markets is not an option that exercises any discipline over excessive or non-competitive rates in the forward market.

the fact that current spot prices were influencing expectations about future spot prices, raising forward market prices by as much as 33%. *See* Supp. J.A. 199sa-200sa, 206sa. It is precisely the fact that the forward market is functioning that requires an inquiry into the matter initially set for hearing: whether spot market dysfunction raised forward prices. It is not a basis for ruling that question irrelevant.

For this reason, FERC's observation that it found no manipulation "specific to" the individual long-term contracts being challenged misses the point. Forward contract prices can be unjustly and unreasonably high without such "specific manipulation."[27] The mandate of the FPA is to ensure just-and-reasonable rates. It is irrelevant to the consumer whether she must pay $300/MWh because market dysfunction or manipulation affected her rate directly or indirectly. The rate still falls outside the zone of reasonableness, and the basis for presuming justness and reasonableness fails.

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[27] The FPA does not preclude only unjust and unreasonable rates that are the result of manipulative behavior. Moreover, it would be arbitrary and capricious for FERC to deny relief in the CPUC docket on an alleged finding of an absence of such "specific" manipulation, when it forbade discovery of the topic of, and excluded any evidence regarding, the specific challenged sellers' exercise of market power. *See* Pet. App. 327a (*PUC*).

C. FERC's Market Monitoring Did Not Provide Assurance Of Competitive Conditions At The Time Of Contracting.

The circumstances of this case do not require the Court to evaluate the reporting requirements to which FERC now refers in its Brief[28] because those requirements, such as they were, were neither followed nor enforced, as FERC now belatedly acknowledges. *See* FERC Br. 9 (citing *Lockyer*, 383 F.3d at 1014 ("[T]he reporting requirements were not followed in the period at issue. Indeed, non-compliance with FERC's reporting requirements was rampant throughout California's energy crisis.")). FERC specifically acknowledged that during the height of the energy crisis the quarterly reports of several major wholesalers, including Dynegy and Mirant, failed to include the transaction-specific data which at least theoretically could have provided a basis to monitor the California energy market. *B.C. Power Exch. Corp.*, 99 FERC at 62,066 (2002). As explained by the court of appeals in its *Lockyer* decision, "[w]ithout the required filings, neither FERC nor any affected party may challenge the rate," and "[i]f the ability to monitor the market, or gauge the 'just and reasonable' nature of the rates is eliminated, then effective

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[28] *See* FERC Br. 7 ("The reporting requirement provides a means for the Commission and the public to identify pricing trends or discriminatory patterns that might suggest the exercise of market power.") (citing *B.C. Power Exch. Corp.*, 99 FERC ¶61,247 at 62,063 (2002)).

federal regulation is removed altogether." 383 F.3d at 1015-16.[29] Given these realities of the regulatory environment during the time period at issue, the proposition that reporting requirements and other "informational filings" sufficed to monitor market power and the justness and reasonableness of rates cannot be credited.

Similarly, changes made by Congress in the Energy Policy Act of 2005[30] and by FERC in its administration of its market-based rate regime, FERC Br. 29-32, obviously cannot retroactively cure the fatal deficiencies that *Lockyer* identified in the program that existed at the time of the 2000-2001 energy crisis; if anything, those subsequent measures serve only to buttress *Lockyer*'s core holding that the system at issue in this case was inadequate to fulfill the FPA's mandate. *See* FERC Br. 33 ("The point is not that the market-based system cannot be improved – both Congress and the Commission have taken steps to improve the process based on lessons learned from the 2000-2001 Western energy crisis.").[31]

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[29] Contrary to FERC's suggestion, the *Lockyer* decision did not "sustain[ ]" the "basic framework for approving market-based rates," FERC Br. 33; *Lockyer*, like the court of appeals' decisions in *PUD* and *PUC*, ruled that if FERC is going to use a market-based approach, FERC must, as one necessary predicate, have in place the functional equivalent of the actual statutory filing requirement. *Lockyer*, 383 F.3d at 1016.

[30] Pub. L. No. 109-58, 119 Stat. 594.

[31] In a detailed audit released in June 2002, the General Accounting Office ("GAO") found that FERC lacked the systems

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The contracts challenged here were executed during this period of FERC-documented dysfunction and rampant non-compliance with market monitoring "safeguards." *See, e.g.*, J.A. 489a, 520a (Dec. 15, 2000 Order). Under these circumstances, the court of appeals correctly observed that FERC's initial market-power analysis – in some instances made more than six years prior to contract formation – "had so atrophied" by the time the challenged contracts were executed that the "basis for assuming the rates established would be within the statutorily mandated 'just and reasonable' range had evaporated." Pet. App. 53a-54a (*PUD*).[32] Accordingly, the court held that the

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and personnel required to effectively monitor competitive wholesale power markets. *See* General Accounting Office, *Energy Markets: Concerted Actions Needed by FERC to Confront Challenges That Impede Effective Oversight* (June 2002). The GAO stated, "At the current time, FERC is not adequately performing the oversight that is needed to ensure that the prices produced by these markets are just and reasonable and therefore it is not fulfilling its regulatory mandate. . . . As the California energy crisis has made adequately clear, FERC simply cannot let the markets continue to go unmonitored for this length of time." *Id.* at 50-51. FERC's Chairman endorsed the GAO's findings. *Id.* at 52-53. Senate hearings following FERC's request for expanded civil penalty authority (ultimately enacted in the Energy Policy Act of 2005) paint an equally grim picture of FERC's protection of the public during the Western energy crisis. *See generally, Asleep at the Switch: FERC's Oversight of Enron Corporation: Hearing Before the S. Comm. on Gov't Affairs*, 107th Cong. 107-854 (2002).

[32] Sempra suggests that because it received market rate authority just three weeks before it signed its contract with CDWR, FERC implicitly found that the market was functioning and hence producing reasonable rates at the time of contract

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opportunity to review the justness and reasonableness of these contracts had to be, but was not, provided in the adjudicatory proceedings below, and remanded for that purpose. Pet. App. 46a-60a, 66a (*PUD*); Pet. App. 324a-30a (*PUC*). The FPA requires at least that much, if not more.

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formation. Coral Br. 18. In fact, Sempra in its application for market-based rate authority specifically disavowed any suggestion that the market was competitive, noting that its application was "not premised on the assumption that markets in California are working efficiently or competitively under current circumstances. What [Sempra] seeks . . . [is] simply to be put on the same footing as other suppliers in California or elsewhere. . . ." Application of Sempra for Market-Based Rates, FERC Docket No. ER 01-1178-000 (Feb. 6, 2001).

That Morgan Stanley's market-based rate authorization was renewed within three months of the contract's effective date of the Morgan Stanley/Snohomish contract also fails to compel a contrary result. MSCG Br. 43. FERC did not approve Morgan Stanley's application for renewal of its market-based rate authority (which had been filed on November 8, 2000) until June 26, 2001, after FERC had issued its price mitigation order on June 19, 2001 instituting a cap on spot market prices in several western states. J.A. 678a-80a (June 19, 2000 Order). The Morgan Stanley contract, however, was executed in late January 2001 (with wholesale deliveries starting on April 1, 2001), before the price cap was set and other market mitigation measures undertaken. MSCG Br. 14.

D. These Section 206 Rate Challenges Are Not Procedurally Precluded By The Absence Of A Challenge To The Sellers' Market-Based Authority Prior To Contracting.

Petitioners also assert that the contract challenges here are procedurally improper because if a prospective buyer believes that it lacks equal bargaining power with the seller, it must challenge the seller's market-based rate authority prior to contracting. *See* MSCG Br. 43; Coral Br. 19-20. Fundamentally, this assertion ignores the crucial fact that nothing in the FPA imposes such a restriction on the ability of an interested party to initiate a proceeding for review of the justness and reasonableness of contract rates. To the contrary, the FPA requires filing of contracts prior to their rates becoming effective, so that parties like CEOB and CPUC have an opportunity on behalf of the public to inspect them, and where appropriate, to "call on the utility to show" in a Section 205 proceeding, the lawfulness of its rate, "not in some theoretical sense" based on the prior grant of market-based rate authority, "but as it practically affects the parties at the time it is sought to be imposed." *MEUA*, 485 F.2d at 974. Petitioners' suggestion that prior to the execution of a contract containing an actual rate, the public is required to shoulder the burden of proving in a Section 206 proceeding that a seller's market-based rate authority must be revoked not only finds no support in the FPA, it ignores the practical reality that the public and its

representatives normally would not be aware that a particular seller was about to execute a contract affecting the public and therefore would not know that it was time, under Petitioners' scheme, to file a challenge to that seller's market-based rate authority.

In any event, in the highly unusual context of the Western energy crisis, CPUC and others did in fact challenge sellers' market-based rate authority before CDWR contracted with them. FERC entered its December 15, 2000 Order in complaint proceedings (in which CPUC and CEOB were intervenors) seeking to put limits on sellers' market-based rate authority, namely to condition their market-based rate authority on the imposition of a hard price cap in the spot markets. J.A. 432a-36a (Aug. 23, 2000 Order). FERC rejected the requested limits in its December 15, 2000 Order and instead specifically directed the parties to expeditiously enter into forward contracts. In doing so, however, FERC stated that it would "be vigilant in monitoring the possible exercise of market power" and "monitor prices in those [forward] markets" in order "[t]o address concerns about potentially unjust and unreasonable rates." J.A. 520a, 522a. Thus, market participants were on notice that FERC determined not to delay forward contracting with proceedings on the revocation of sellers' market-based

rate authority as some putative precondition to later just-and-reasonable review.[33]

Finally, conditions during the energy crisis illustrate the impracticality of Petitioners' suggested scheme. At the time the challenged contracts were executed, CDWR was pursuing an emergency purchasing program to keep power on throughout California. Had CDWR challenged every seller's market-based authority before CDWR entered into any forward contracts as Petitioners and their *amici* suggest, CDWR's procurement of the necessary power may have slowed or even stopped, potentially leading to continuing rolling blackouts and the public safety issues inherent thereto. FERC rejected that approach to addressing the energy crisis. Indeed, far from requiring prior challenge to a seller's market-based rate authority, FERC during the crisis notably granted market-based rate authority even when a seller expressly disavowed any claim that the markets were functioning competitively. *See* note 32, *supra*.

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[33] Coral, Dynegy, PPM and Sempra expressly acknowledge that they had notice of FERC's December 15 Order when they executed the challenged contracts: "FERC's actions and the underlying market conditions were well known to everyone in the Western energy markets when these contracts were executed. . . ." Coral Br. 17.

IV. NEITHER FERC'S ORDERS NOR ITS *POST HOC* RATIONALIZATIONS ARE ENTITLED TO *CHEVRON* DEFERENCE.

FERC now argues that its orders below should have been upheld because it reasonably interpreted the FPA to provide for only limited public interest review, and that the court of appeals should have deferred to its judgment in applying this Court's decisions in *Mobile* and *Sierra*. FERC Br. 20-26. FERC's arguments are not entitled to any deference.

A. *Post Hoc* Rationalizations Cannot Salvage FERC's Legal Error.

FERC points to no place in its orders below where it even purported to resolve some ambiguity in the statutory term "just and reasonable." That is because FERC did not construe a statutory ambiguity or fill a statutory gap; rather it held, against the plain language of the FPA, there were two different standards, "just and reasonable" and "public interest," and applied the wrong one. *E.g.*, J.A. 1275a-76a (Snohomish Order); J.A. 1346a (CPUC Order).

In pursuit of deference from this Court, FERC disavows the core errors that it committed below. FERC now agrees that only one standard applies to its review of rates: whether they are just and reasonable. *See* FERC Br. 21. Acknowledging that all rates must be just and reasonable, FERC has abandoned its ruling below that the FPA allows that *some* rates can be unjust and unreasonable, *i.e.*, that it is irrelevant

to FERC's review whether the contracts were unjust and unreasonable when signed. FERC similarly does a complete about-face regarding the relevance of market dysfunction. Having ruled below that the impact of spot market dysfunction on forward contract prices was not relevant, FERC now states on appeal that "market dysfunction is certainly relevant to whether the public interest requires contract modification." FERC Br. 18. FERC claims that, instead of applying a different test, it merely ruled that the single standard does not "appl[y] in the same way in every context" and imposes a heavy burden to justify modifying a rate agreed upon in a contract entered pursuant to market-based rate authority. FERC Br. 21-22.

The agency cannot re-write its order on appeal. It is black-letter administrative law that an agency decision can be justified on appeal based only on the reasoning contained in its decision, and not on alternate grounds. *See SEC v. Chenery Corp.*, 318 U.S. 80, 87 (1943) ("The grounds upon which an administrative order must be judged are those upon which the record discloses that its action was based.") As this Court held in *Texaco,* it "cannot 'accept counsel's *post hoc* rationalizations for agency action'; for an agency's order must be upheld, if at all, 'on the same basis articulated in the order by the agency itself.'" 417 U.S. at 397 (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168-69 (1962)). The FPA provides a single just-and-reasonable standard, and FERC made clear in its decisions that it was not

applying it. FERC's order must be vacated and remanded for the patent legal error in the standard applied.

B. FERC's Interpretations Of The FPA Are Entitled To No Deference Because They Contravene The Plain Language And The Core Purpose Of The Act.

As noted above in Section I.A, *supra*, the FPA requires all rates to be just and reasonable and the core statutory purpose is to protect the public from bearing excessive rates. Under this statutory mandate, the Court has ruled that no rates that exceed the just-and-reasonable standard, however minimally, are allowed. *Texaco*, 417 U.S. at 399. Nonetheless, FERC determined below that there was a second statutory standard, and it was thus irrelevant whether the contract rates were just and reasonable *ab initio* and whether spot market dysfunction affected the contract prices at issue. FERC's truly unprecedented ruling is so contrary to the plain language and core purpose of the FPA that it is not entitled to any deference. *See Chevron, U.S.A., Inc. v. Natural Res. Defense Council, Inc.*, 467 U.S. 837, 842 (1984) ("If the intent of Congress is clear, that is the end of the matter."); *MCI*, 512 U.S. at 229 ("[A]n agency's interpretation of a statute is not entitled to deference when it goes beyond the meaning that the statute can bear.").

FERC's recasting on appeal of its decision below is equally contrary to the plain language and core purpose of the FPA, for FERC proposes to do away with any opportunity for the public to have the justness and reasonableness of an actual contract rate determined by FERC and instead would turn the prior grant of market-based rate authority into an irrebuttable presumption of the justness and reasonableness of any subsequently negotiated rate. At its core, FERC's *post hoc* rationalization is all the less entitled to any deference for its plain contravention of the FPA.

C. FERC's Construction Of *Mobile* And *Sierra* Is Not Entitled To Deference.

Below, FERC construed this Court's precedents in *Mobile* and *Sierra* to mean that the statutory "just and reasonable" standard does not apply, and to mean that it is irrelevant whether rates are unjust and unreasonable at the time of contract formation due to market dysfunction. FERC's construction of Supreme Court precedent also is not entitled to any deference; it is not a matter that Congress can have delegated to FERC. *See Marbury v. Madison*, 5 U.S. (1 Cranch) 137, 177 (1803) ("It is emphatically the province and duty of the judicial department to say what the law is."); *see also Chenery*, 318 U.S. at 92-93 (reviewing agency's order under a *de novo* standard because agency "did not rely upon its special administrative competence," but rather "purported merely to be applying an existing judge-made rule of equity").

As FERC rightly points out, in *Sierra* itself, this Court did not defer to the Commission's express finding that the contract at issue was "unreasonable," because the Commission had considered the wrong category of factors (impact on the utility's rate of return) in making that judgment. FERC Br. 4 (citing *Sierra*, 350 U.S. at 354, 355). Accordingly, FERC's implicit suggestion that its application of the standard must be given deference, *see* FERC Br. 20-26, is not correct. Here, as in *Sierra*, FERC considered the wrong category of factors in carrying out its duty to ensure that rates are just and reasonable – in this case, by deeming irrelevant the core statutory issues – and its decision is no more entitled to deference than was its decision in *Sierra*.

CONCLUSION

FERC's rulings in these proceedings effectively eliminate the regulation of rates in the bulk of the wholesale electricity markets, especially the long-term forward markets. In its place, consumers would be required to bear whatever burden is agreed upon by contracting parties in the market, and to do so whether or not the markets are competitive. In this manner, FERC would replace Congress's assigned regulatory guardian with the hand of the market, even when that hand is not merely invisible but is altogether absent. In finding such a result fundamentally at odds with the FPA, the court of appeals was right.

For all the foregoing reasons, the judgment of the court of appeals should be affirmed.

Respectfully submitted,

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